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| Case #5 |
| Southwest Airlines |
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**Analysis and Evaluation**

U.S. Airline Industry 1990s

By the late 1980s, eight airlines controlled 91 percent of the U.S. traffic, but their financial condition was fragile due to a decade of marginal profitability. By the early 1990s, due to a recession and doubling of oil prices due to the Gulf War, the industry witnessed bankruptcy and collapse. The industry as a whole reported a cumulative deficit of $12 billion from 1990 through 1993.

Between 1989 and 1992, 6 major U.S. airlines (including Continental Airlines) filed for protection under Chapter 11 of the U.S. Bankruptcy Code. While some companies closed afterwards, 3 emerged from bankruptcy between 1993 and 1994 (including Continental Airlines). At year-end 1994, the industry started to look as if it might turn up considering the industry as a whole recorded a modest operating profit.

During this time of despair and collapse for many Airlines, new airlines were formed. Most of these new Airlines strategically positioned themselves as “low-fare, low-frill” airlines and benefited from the cheap supply of aircraft grounded by major carriers from 1989 to 1993. These new entrants had cost structures that were significantly below most major carriers.

Although these new entrants accounted for a small percentage of industry revenue, their pricing practices depressed fares on a growing number of routes also served by major carriers. By 1994, 92 percent of airline passengers bought their tickets at a discount, paying on average just 35 percent of the posted full fare.

Industry Costs

Within the airline industry, the majority of carriers costs including labor, fuel, facilities, and planes are fixed regardless of the amount of passengers served. The largest single costs were labor and fuel and these represent over half of the fixed costs. Labor costs, by comparison, can be seen as a controllable expense within limits, and as a result, more than 100,000 airline workers lost their jobs between 1989 and 1994.

Southwest Airlines

Southwest Airlines was the 8th largest airline in the U.S. in 1994 based on number of revenue passenger miles flown. They recorded net income of $179.3 million on total operating revenue of $2.6 billion in 1994 and achieved 22 consecutive profitable years (an unmatched feat in the industry over the past two decades). They were founded on the motto that “better quality plus lesser price equals value, plus spiritual attitude of our employees equals unbeatable.”

Southwest began scheduled service on June 18, 1971 and is dedicated to providing short-haul, point-to-point, low-fare, high-frequency service to airline passengers and is committed to exceptional customer service. They were founded on a mixture of relentless attention to customer service and operations, creative marketing, and commitment to their people with a healthy dose of fun for good measure.

A sense of humor, compassion for passengers and fellow workers, a desire to work, and a positive outlook manifested themselves in customer service a Southwest. As a result, in 1994, they won the annual unofficial “triple crown” of the airline industry for the 3rd consecutive year by ranking first among major carriers in the areas of on-time performance, baggage handling, and overall customer satisfaction.

Their competitive advantage of being able to lower their operating costs and pass the savings on to their customers in the form of low cost fares comes from a variety of initiatives:

* Quick turnaround time from ground to air. Most planes were turned in 15 minutes compared to the U.S. industry average of 55 minutes.
* Avoidance of major airline hubs in large cities which cut back on aircraft taxi time and airport circling while awaiting landing permission.
* Booking reservations and providing seat arrangements. Southwest does not assign seats.
* Bypassing travel agents. In order to book with Southwest, you must actually contact Southwest Airlines. While most airlines rely on travel agencies to write up to 90% of their tickets, Southwest saves on commission costs (about $30 million a year).
* Only beverage and snacks are served on flights.
* Southwest only flies Boeing 737 jets in all couch configurations (no first class seats) which reduces aircraft maintenance since only one type of jet needs to be serviced. This allowed Southwest to specialize in their jets and they are ranked among the safest jets in the world and less than 1% of Southwest flights were cancelled or delayed due to mechanical incidents in 1994.

Southwest Airlines also makes a great effort in the marketing department. They defined a personality for the company as well as a market niche. Service, convenience and price represented three pillars of Southwest’s marketing effort. They have always seen the automobile as their main competitor and strive to provide value for customers to leave their cars at home and fly with them instead. They also offer a frequent flyer program called “The Company Club” which provides a customer a free flight if they take 8 round trip flights within 12 months or for 50 round trips in one year, they customer received a companion pass valid for one year.

Their other big niche is the commitment to their people and they want their employees to know that they will always be there for them. They strive to foster close working relationships. They were also the first airline to offer an employee profit-sharing plan and this has led to the fact that 10% of the company is now owned by employees.

“Shuttle By United”

In October of 1994, the maiden flight of “Shuttle By United” departed. This initiative by united was aimed at getting them back into the market and getting their passengers back (from Southwest). Until the late 1980s, United was the dominant carrier at the Oakland airport but left in the early 1990s due head to head completion from Southwest. Afterwards, Oakland had become Southwest’s main base of Northern California and was of the fastest growing of California’s ten major airports in terms of traffic.

This initiative was designed to replicate many operational features of Southwest: point-to-point service, low fares, frequents flights, and minimal amenities; lowering operating costs was a high priority. They featured the same jets, strived for a 20 minute turnaround time, only offered beverages and snacks, and tried to motivate their employees to provide exceptional customer service. They also implemented a new boarding system that went windows, middle aisle. The only difference was that, unlike Southwest, they did offer 1st class seating for an extra $20 per seat.

By 1994, “Shuttle By United” was in direct competition with Southwest on 9 different routes. In 1994 however, United reported that the cost per available seat mile of its shuttle operation had not yet achieved its targeted 7.5 cents and stated that they did not even vaguely come close to the 7.08 cost of Southwest.

Southwest responded to this initiative by preparing months in advance. They committed additional aircraft to the California market to boost flight frequencies on competitive routes. They also boosted their advertising and promotion budget with particular emphasis on city-pairs where “Shuttle By United” would be competing directly with Southwest. They decided to keep their walk-up fare at $69 during the 4th quarter of 1994. However, they were heavily promoting their 21-day advance fares and other discount fares.

New Changes To “Shuttle By United”

It is now at the attention of Southwest that United has made two changes to their initiative: 1) In April 1995, United would cease their Oakland-Ontario route, and 2) the one way walk up price will be increased by $10 on all 14 routes which previously matched Southwest.

This marked the fact that United’s “Shuttle By United” strategy was obviously failing as they could not compete with these reduced costs and were unable to match Southwest’ cost structure. This is great news for Southwest because they will be losing competition on some flight plans.

Since United is raising their walk-up fare by $10, Southwest has the option to increase their walk-up fare as well. This could increase profits for the company while allowing them to remain competitive. However, the fact that they are able to undercut United could be used to their advantage as well; they could advertise and promote their low walk-up rate and expect an increase in demand for that service.

Southwest’s unique cost structure provides them with an advantage within the industry and allows them to be more flexible with ticket prices. However, they must be prepared for entrants or substitutes who can and will mimic their cost structure (for example: not using travel agents and only using one type of jet).

**Recommendation**

Southwest should keep their walk-up fares at the same price and advertise this discounted service to customers. While this change for United should not be seen as a threat but an opportunity, Southwest should not worry about changing their prices or services because they already control the market price. However, they should continue to seek out other cost saving strategies and competitive advantages on top of their current ones in case of other companies introducing initiatives such as the “Shuttle By United” which will compete with them in the future